Policymakers and political leaders should take the opportunity to explore alternative ways of taxing property. There are only so many ways that the government can tax the value of real property. Traditionally, the property tax was levied on the value of the land and improvements. While this system has generally served the nation well, there is a more effective and efficient way of taxing property.

Over the past several years, there has been a growing interest in the idea of land value taxation. As part of comprehensive property tax reform, local governments should seriously consider the adoption of some form of land value taxation. First championed by 19th century reformer Henry George, the concept of land value taxation involves simply taxing the value of land while exempting improvements. I am not suggesting that local governments consider exempting all improvements. Rather, they should take the more limited step of exploring split-rate systems, in which land is taxed at a higher rate than improvements.

Land value taxation could assist local governments in meeting their dual imperatives. Land value taxation could provide a stable, reliable source of revenue without adversely affecting economic growth. Increasing the tax on land, of course, will not enhance development. But, almost as important, it will not seriously hinder development. Reducing the tax burden on improvements, however, would have a significant impact on development. For local governments, especially central cities, land value taxation may be a particularly attractive source of revenue. It would create an incentive to develop underutilized space, such as empty buildings and vacant lots.

Can it work? Nobel laureates in economics think it can. Politically, of course, such reforms can be a tough sell, especially to those people who possess much land but few improvements. Some studies show, however, that average homeowners would see their property tax burden decrease if land was taxed at a higher rate than improvements. In any event, land taxation should be investigated as part of a comprehensive tax reform effort.

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To Preserve Local Government, It's Time to Save the Property Tax

State Tax Notes Contributing Editor David Brunori makes the case for saving the local property tax, pointing out the importance of self-funding by local governments to meeting the needs of their citizens and noting the flaws of other tax options.

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=============== SUMMARY ===============

State Tax Notes Contributing Editor David Brunori makes the case for saving the local property tax, pointing out the importance of self-funding by local governments to meeting the needs of their citizens, noting the flaws of other local tax options, and concluding with proposals for reforming and reviving local property taxation. There has been much discussion in recent years about the future of local government finance. Scholars, government leaders, and representatives of a wide variety of organizations have been debating how local governments will pay for public services as we enter the 21st century. Most of the discussions to date have focused on relatively narrow, albeit important, subjects, such as school finance, exempt properties, and electronic commerce and the local sales tax. But I think that the long-term fiscal problems facing local governments are much more serious than the debate so far suggests. In fact, I believe that the important role that local governments serve in our federalist system is in jeopardy.

Is this a dramatic statement? Perhaps, but I will go further.

The very existence of local government -- at least the system of local governments that we have come to know -- is in jeopardy without a significant change in the way local government is financed. Indeed, I think there is a distinct possibility that local government will be weakened to the point of irrelevancy unless the cities, counties, and towns reestablish a viable source of revenue -- one that they control. And the only revenue source that will ensure strong and vibrant local government is the property tax.

These statements are intentionally provocative. But the potential long-term consequences of not addressing the problems with local government finance are very serious. Essentially, I believe that without significant reforms, local governments will play a far- diminished role in American public life. I base this belief on some very basic theories set forth below, none of which are particularly controversial, or even novel.

I am assuming, of course, that it is important -- indeed, perhaps imperative -- that local governments continue to play an active role in the federalist system. Most people, I suspect, would say that local governments have played and should continue to play such a role. Suffice it to say the three levels of American government have served the people well; indeed, this federalist system helped create the freest, strongest, and richest nation in recorded history. And I think that our inclination should be to protect and strengthen our federalist system.

Theory No. 1: Local Viability Depends on Own-Source Revenue

The three levels of government have worked because each level is governed democratically. We, the people, elect our national, state, and local leaders, and those leaders are so accountable to the public. One way that accountability works is that elected officials provide the public services -- be they spaceships or kindergarten teachers -- that the citizens demand. To do that, officials raise and lower taxes to pay for those services. If the citizens are not getting the services they want (or if they are getting too much), they will express their displeasure at the ballot box.

So the linchpin in the system is having the ability to raise (or lower) taxes in order to provide the necessary level of services. The system has worked because the three levels of government have enjoyed the access to their own sources of revenue. The federal government primarily uses income taxes. The states use a combination of income and consumption taxes. And local governments have traditionally relied on property taxes to pay for the services their citizens demand.

The connection between successful local government and the ability to raise revenue is undeniable. Citizens of local jurisdictions demand various public services. They want well-staffed police and fire departments, responsive ambulance services, paved roads, regular trash collection, and good schools. Local governments are best able to provide these fundamental public services. Local officials, as opposed to state or federal politicians, know what local citizens need and want. And local officials know the costs of providing these services. They know what it costs -- in their area -- to hire a new teacher, buy a ton of tar for the roads, or lease a dump truck. You don't see local governments spending $100 for a hammer or $600 for a toilet seat.

If the costs of these services go up, local officials and the citizens decide how and whether to pay. Cities and counties can raise taxes. They can curtail services. They can borrow money. They have flexibility to meet the needs of their citizens. And if they are not meeting their needs, the citizens can and often do choose new leaders.

Because localities have controlled their revenue, they have been the most responsive, accountable, and innovative segments of the federal system. For local governments to retain their status as important components in the American system of government, they must have access to their own sources of revenue.

Theory No. 2: The Property Tax Is in Trouble

The property tax was traditionally the primary revenue source for local governments. Not long ago, local governments raised about 80 percent of their own-source revenue from real property taxes. But the tax has been in steady decline for a quarter-century. Indeed, nationwide the property tax has continued to fall as a percentage of local government revenue. While there are wide variations among the states, the property tax now accounts for less than 40 percent of local government tax revenue.

The reasons for this precipitous decline are well-known. First, the property tax revolts that began in the late 1970s wreaked havoc on the tax. Today, 44 states have some restrictions on property taxation. And in 33 of those states, those restrictions are substantial -- resulting in property tax revenue declines of 15 percent or more. These limitations include rate and assessment limits and rollback provisions.

The revolts arose from a variety of problems with the property tax, including unfair assessments, large single tax bills, and hardships on low- and fixed-income property owners. For years, public opinion polls showed that the property tax was viewed as "the worst tax."

The property tax revolts seriously hampered the ability of local governments to raise revenue. And it should be noted that in many states, political leaders taking advantage of antitax sentiments promised increased state aid to replace lost property tax revenue. That increased aid never materialized -- at least not to the extent of the lost revenue.

The tax revolts are not the only problem. Another challenge has been a proliferation of property tax exemptions in the name of economic development. Most people who follow state and local tax matters are well aware of the trend. State and local governments desiring to attract jobs and investment provide property (and many other kinds of tax) breaks to companies promising to relocate to or remain in the jurisdiction.

Targeted tax incentives of this kind are prime examples of bad tax policy. They are often unnecessary. They are unfair from the perspectives of horizontal and vertical equity alike. And they are a gross violation of the principle that the tax code should minimize effects on economic activity. Despite these theoretical arguments against incentives, they have proliferated. Thousands of economic development exemptions are granted every year. And many veteran observers have come to conclude -- incorrectly, I believe -- that such incentives are inevitable. The amount of money given away every year in the form of property tax incentives is difficult to determine because most states and local governments do not have tax expenditure reports.

The result has been a further shrinking of the property tax base. I note that most tax incentives involve income and property taxes. When property tax exemptions are adopted, the state usually promises to reimburse the local governments for lost revenue. But once again, the states rarely follow through with enough funds to cover the loss.

Yet another challenge to the property tax has been the dramatic increase in the value of property held by charities and nonprofit organizations over the past quarter-century. All states have been affected. A whole class of property is exempt from taxation -- property held by churches, synagogues, schools, charities, universities, and other nonprofits. In Virginia in 1998, for example, $60 billion of value was exempt from property tax, costing local governments more than $650 million of revenue.

This essay is not meant to spur debate on the efficacy or appropriateness of charitable tax exemptions. But such exemptions further shrink the property tax base of most local governments. And exemptions arguably cause the tax burdens placed on nonexempt property to increase. What's more, those organizations receiving exemptions use public services, which generally must be paid for by nonexempt taxpayers. This problem has become so acute that national organizations such as the Urban Institute and the Lincoln Institute of Land Policy have held conferences to address the issue.

It should be noted that payments in lieu of taxes (PILOTs) are not universally used. Nor do PILOTs remotely come close to covering the revenue that would be raised if the property were not exempt.

A further problem with the property tax has been the issue of school finance. Traditionally, local governments were primarily responsible for paying for elementary and secondary school education. And local governments relied heavily on the property tax to pay the bills. Of course, some jurisdictions had a property tax base to pay more for teachers, buildings, computers, and the like than poorer communities. The bottom line is that kids in wealthier communities had more money per capita spent on their education than kids in poorer cities and counties. And that usually translated into better schools.

For the past quarter-century, there have been a growing number of legal and political challenges to the inequality of public education finance. Courts in 19 states have declared that using the local property tax as the primary means of paying for schools is illegal. Courts have ordered states to "equalize" funding of schools between rich and poor communities. The states usually reacted by earmarking certain statewide taxes to pay the costs of the public schools. Michigan imposed an additional 1 percentage point statewide sales tax to pay for all public school expenses (and drastically cut the property tax). New Hampshire and Vermont imposed essentially statewide property taxes, with funds being distributed from wealthy ("donor") towns to poorer ("donee") towns. As readers of State Tax Notes are well aware, the shift to statewide property taxes proved to be politically disastrous. The property tax works if it is used to fund local governments -- and does not work if it is used to redistribute wealth.

The problem of fiscal disparities is not an indictment of the property tax. Indeed, research by noted economists such as Therese J. McGuire of the University of Illinois has indicated that local-option sales and income taxes result in similar, or at times greater, disparities between rich and poor jurisdictions.

But because the states have begun to fund a greater share of elementary and secondary education, reliance on the property tax has been reduced. The school finance debacle has made it politically more difficult to use the property tax as a means of financing local government in general. The jury is still out on this experiment. Studies have shown that in California, overall public education spending has fallen dramatically.

In the end, the tax revolts, incentives, and exemptions and the school financing controversy have reduced the ability of local governments to rely on the property tax.

Theory No. 3: There Are No Alternatives for Localities

Despite the fact the property tax is in trouble, there are no viable alternatives. There is no other way of effectively financing local government with revenue under the control of the local political jurisdiction.

Local-Option Sales Taxes. For many years, local-option sales taxes were growing in importance, as 33 of the 45 states imposing a sales tax allowed their local governments to tax consumption. Even Alaska, which levies no statewide sales tax, allows local governments to do so. Thousands of jurisdictions in many states now have the ability to impose the tax.

But the trend toward local-option sales taxes is waning. First, the overall sales tax base has been steadily falling as more goods and services have been deemed exempt. The continuing shift from an economy based on manufacturing and tangible personal property to one dominated by services and intangible personal property has greatly reduced the tax base. Moreover, political leaders, perhaps recognizing the inherent regressivity of the tax, have exempted virtually all goods and services deemed necessities. Most of what Americans consume is not subject to sales tax.

The debacle over electronic commerce has also lessened interest in local-option sales taxes. State and local governments stand to lose billions of dollars in sales tax revenue as consumers increase their Internet and mail-order purchases. As State Tax Notes readers are well aware, numerous efforts are under way to address the problem of taxation of electronic commerce -- but those efforts do not generally favor local-option sales taxes.

Political leaders are recognizing a host of other problems with local-option sales taxes. For example, they create intense competition for retail development. When local governments are restricted from using property tax revenue, they turn when possible to the local sales tax. This leads many communities to encourage the building (indeed, often overbuilding) of retail shopping space to protect their revenue streams. As a result, many communities see a large growth in the number of retail stores. The owners of those stores, ironically, do not generally favor local-option sales taxes.

Other problems with the local-option sales tax include reduced flexibility of imposing or repealing statewide sales taxes and the fact that local-option sales taxes add to the overall regressivity of the state and local tax systems. States are also realizing that shifting from reliance on property taxes to reliance on sales taxes increases federal tax liability, at least for citizens who itemize.

In many states, local governments have asked for more authority to impose sales taxes for the purpose of supporting education, an idea that initially enjoyed widespread support. But rural towns, counties, and school districts soon took exception to such policies. The problem is that rural communities do not benefit from the local- option tax revenues. In fact, in some ways they are worse off. Residents of rural communities tend to shop and pay the local-option sales tax in urban areas. Thus, the extra money for schools flows mainly to the urban counties, but the burdens are exported to the residents of the rural counties.

The end result is growing opposition to new or enhanced local- option sales taxes. In the past year, legislatures in Montana, Maine, and New Hampshire rejected efforts to allow local-option sales taxes, primarily because the business community joined rural jurisdictions to oppose the measures. In Iowa, there was an effort to repeal local- option sales tax authority and replace it with a 1 percentage point addition to the statewide sales tax, the revenue from which would be distributed across the state. Rural communities desperately fought for the statewide levy. But urban areas successfully lobbied to defeat the measure. Now the rural communities are suing the state, alleging that they cannot fund their schools adequately.

Local-Option Income Taxes. After the 1986 federal tax reform act, many people thought that local-option income taxes, because they remained deductible from federal taxable income, would become an important source of local revenue. They were attractive because most are administered by the state. But only 15 states allow local-option income taxes. And only two of those states (Pennsylvania and Ohio) use them on a large scale.

There are several reasons why local governments have not taxed income more extensively. First, there is a widespread belief that local-option income taxes have a detrimental effect on the local economy, hampering efforts to attract homeowners and businesses to the jurisdiction and retain them once they get there.

The academic research is mixed as to whether local-option income taxes actually deter economic development. But extensive anecdotal evidence has created a powerful perception that local governments are better off without such taxes. This perception feeds the existing bias among state political leaders against income taxes. Over the past two decades, when states ran budget surpluses, they tended to cut income taxes. When they needed more revenue, they tended to raise sales and excise taxes. This has the effect of making an already regressive system all the more regressive.

In addition, there are administrative reasons why the tax is not more widely used. Such taxes are generally believed to reduce states' income tax flexibility. Broadening or narrowing the tax base and increasing or reducing rates become more difficult for the states if local governments are also relying on the tax. Moreover, there is a lingering question as to whether the place of work or residence has authority to impose the tax, although in most states it's the place of work.

The local-option income tax is not a viable alternative for local governments and will not, in my opinion, move beyond its current status.

Other Local-Option Taxes. As most policymakers and scholars determined long ago, local-option business taxes are not a viable source of revenue for local governments. Only 14 states still allow them, and in most of these states there are powerful movements for repeal. The administrative and compliance costs of such taxes are high. Local business taxes fuel inefficient interjurisdictional competition. And taxes such as those on gross receipts are viewed as particularly unfair to small and start-up business.

Local-option excise taxes have also proved to be an inconsistent and ineffective means of raising revenue, and such taxes are widely disfavored by public finance experts. Only 14 states allow local governments to impose gasoline taxes, and only 10 allow local governments to impose cigarette taxes. Over the past 25 years, many states have either repealed these laws or rejected attempts to impose them.

User Fees and Charges. User fees and charges are still widely used by local governments -- in large part because of the limitations placed on other sources of revenue. Over the past quarter-century -- essentially since the onset of the tax revolts -- state and local governments have increasingly relied on user fees and charges to fund public services.

This trend is slowing considerably. There are inherent limitations on using fees and charges. At some level, citizens will refrain from using the public service for which fees are charged. Local governments cannot charge fees for services that are widely available, such as police and fire protection. And they cannot fairly charge fees for fundamental services deemed to be necessities. User fees and charges are generally considered quite regressive, a point emphasized more regularly in recent years. Over the preceding decades, local governments in states with significant property tax limitations have imposed fees on just about everything that they can. There are simply few public services left on which a fee can be imposed.

Theory No. 4: Without a Viable Revenue Source, Localities Will Continue to Cede Control to States

Without their own viable sources of revenue, local governments will be forced to rely on the state to fund more public services. As readers are aware, state governments are already funding elementary and secondary education more than ever before. States are also increasingly paying for local transportation services. It is generally accepted that as the local government tax base declines, more services provided by local governments will be paid for by the state.

This is a very dangerous trend. Without an independent source of revenue, the power and authority of local governments are curtailed. And that is bad for American federalism -- indeed, bad for Americans in general. Local governments are more responsive to their citizens because they have the ability and flexibility to provide the services that their citizens demand. Local government is more efficient at providing local services because local government officials know the costs and benefits of those services. Relying on political leaders in the state capitals to fund local police, fire, ambulance, and schools virtually guarantees that those and other essential local public services will not be adequately funded.

As important, in the long run all state (or federal) aid comes with rules and regulations as to how the money can and should be spent. Governors and lawmakers will have a greater say in how money sent to cities, towns, and counties should be used. The historical record suggests that all forms of financial centralization are accompanied by such "strings." This will affect everything from the kinds of books in the local library, to the curriculum in the schools, to the artwork adorning local public buildings.

Increased state funding also creates long-term uncertainties for local government finance. State political leaders will be forced to decide among competing interests. For example, when states run budget surpluses, as they have in recent years, there is always pressure to cut taxes. But the excess revenue may be better spent on local public services. When states run budget deficits, will state lawmakers increase taxes to support local public services? The problem is that it is impossible to determine the effects of state financial control of local government. And that uncertainty alone should give all Americans pause as to the wisdom of ceding financial control over local public services to the states.

The Solution -- Restore the Property Tax

My conclusion is that local governments must have a dependable source of revenue, and that only the property tax can provide that revenue. The property tax must be strengthened and revitalized. Set forth below are several steps that could lead to a more viable property tax and help ensure that American citizens have the option of governing their affairs locally.

First, the public's perception of the property as "the worst tax" must be changed. Many of the problems that have plagued the tax in the past have been addressed. Yet many people -- including scholars who should know better -- persist in characterizing the tax as unpopular. Political leaders and, more important, the public must be shown the positive aspects of the tax: it provides a steady stream of revenue to pay for local public services; compliance and administrative costs are minimal; there is virtually no opportunity to avoid the tax, a fact that honest taxpayers will appreciate; and it is visible -- the citizens know what they are paying and can evaluate what they are getting in return. Most important, the public must realize that property taxes support arguably the most important services they receive, and citizens can control the quantity and quality of those services if they control the property tax.

The educational effort to inform the public and the political leadership has largely been undertaken by such organizations as the Lincoln Institute of Land Policy. But it is time that other organizations with a more direct connection to policymakers, such as those representing local governments, join the effort. True property tax reform is possible only when the tax is viewed in a more positive light.

To complement this effort, the excesses of the property tax revolts must be reversed. What is needed is essentially a property tax "counterrevolt." There is no economic or tax policy justification for rate and assessment limitations. Such limits keep property tax revenue artificially low and merely shift the burden of paying for government to other types of taxes, and to other taxpayers. Moreover, many rate and assessment limitations are effectively undemocratic because they cannot be overturned by a majority of voters or elected officials. Under a principled tax system, taxes serve one goal: to raise adequate revenue to pay for government services demanded by the people through their elected representatives.

Such a suggestion may appear politically infeasible. After all, not many leaders will call for a reversal of the property tax revolts. And I admit that it will take the kind of political courage rarely seen in the tax arena to initiate meaningful reforms. But the call to reverse the excesses of the property tax revolts need not be couched in negative terms. Rather, the call to end rate and assessment limitations should be made in the name of ensuring that people have control over their local governments.

But not all of the results of the property tax revolts should be repealed. Provisions designed to protect low- and fixed-income property owners should be retained. These include homestead exemptions and low-income property tax credits. Moreover, concerns over government revenue windfalls, especially in times of high inflation, can be addressed by retaining or adopting rate rollbacks and other measures designed to ensure that the government collects only enough to meet its budgetary obligations and no more. Excess revenue should be returned to taxpayers.

Such property tax reforms should be tied to corresponding cuts in local-option sales and income taxes, and a reduction in user fees and charges. Lifting rate and assessment limitations will result in greater property tax burdens. Without producing more than that result, the goal of reform cannot be realized. Proponents must call for significant cuts in other taxes.

State and local governments must also address the significant problem of exempt properties. Exemptions for economic development and charitable organizations cost local governments billions of dollars and shift the burden of paying for public services to other taxpayers. Both types of exemptions, however, are politically popular. The perception that incentives spur economic development and the desire to assist cherished nonprofit organizations are powerful forces.

But, as recent conferences on the subject suggest, scholars, policymakers, and political leaders are capable of discussing the issues presented by these exemptions. Despite their proliferation, economic development incentives are increasingly viewed as an inefficient means of creating jobs or spurring growth. There is a growing, although unfortunately still small, movement to curb the use of development incentives. Increased media coverage and the adoption of disclosure laws will shed light on some of the problems associated with targeted tax incentives.

The issue of exemptions for nonprofit organizations presents more difficult problems. Religious, educational, and charitable organizations hold a special place in American society. Repealing property tax exemptions benefiting such organizations would be extremely difficult, if not impossible. But there are ways in which state and local governments can minimize the financial impact of such exemptions. For example, stricter qualification standards can be set for nonprofits receiving exemptions. Localities can also insist that state governments grant more authority to collect payments in lieu of taxes.

State governments must also address the problem of fiscal inequities in education finance. This is and will remain a difficult problem, fraught with legal and political uncertainties. The overall goal is not controversial -- all children should be afforded equal educational opportunities. Children should not be subject to inadequate education merely because of where they live or how much money their parents have. But the answer is not to cede control, financial or political, to the state. Methods of equalizing school spending that do not include reducing local taxing authority must be found.